

BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
SOUTHLAND PUBLISHING CO., INC.

Appearances:

For Appellant: W. R. Zappas,
 President

For Respondent: Burl D. Lack,
 Chief Counsel

O P I N I O N

This appeal is made pursuant to section 25667 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Southland Publishing Co., Inc., against a proposed assessment of additional franchise tax in the amount of \$385.12 for the income year ended March 31, 1959.

The question presented is whether the compensation paid to appellant's president and sole stockholder, Mr. W. R. Zappas, in excess of \$32,900 during the year in question should be allowed as a deductible business expense pursuant to section 24343 of the Revenue and Taxation Code, which provides for a reasonable allowance for salaries or other compensation for personal services actually rendered.

Appellant corporation began its newspaper publishing business in 1949, circulating the Torrance Press biweekly to approximately 30,000 persons located in the Torrance vicinity. Prior to June 1956, the stock was owned equally by Zappas, president, and Mrs. M. Owens, vice president, both of whom were directors. Mrs. Owens was in charge of the classified, editorial, and bookkeeping departments. Zappas was advertising manager and general supervisor.

Upon Mrs. Owens' illness and withdrawal in June 1956, Zappas became sole shareholder, and added many of her duties to his, working long hours and seven days a week. He possesses a college degree in advertising, and previously acquired advertising managerial experience with other newspapers. He was appellant's key employee.

After Mrs. Owens' withdrawal, Zappas' wife, Betty Jo, became vice president and a full time employee, having previously worked part time. She operated the women's section, helped out in other departments, and at times substituted for department heads.,

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On the return for the year on appeal, appellant reported Zappas' salary as \$32,180 and Mrs. Zappas' salary as \$18,920; but appellant's records showed he received \$39,500 (\$30,000 salary and a \$9,500 bonus) and his wife, \$11,600. The original authority for the compensation was a board of directors' resolution dated April 2, 1956, providing for monthly salary payments up to a maximum of \$30,000 a year each for Mrs. Owens and Mr. Zappas, plus "bonus payment commensurate with the net profit accumulated the preceding month." Zappas and Mrs. Owens were the only directors voting.

As of the close of the income year in question, appellant had never paid any dividends. Other pertinent information for the income years ended March 31, 1956, to March 31, 1959, is as follows:

	<u>Sales</u>	<u>Gross Income</u>	<u>Net Income</u>	<u>Zappas' Compensation</u>	<u>Total compensation to officers</u>
1956	\$325,373	\$15213,678	\$14,642	\$11,060	\$20,520
					23,490
1958	121,163	196,970	16,400	19,970	29,970
1959	329,662	179,545	20,798	39,500	51,100

Zappas reduced his sales staff and assumed additional sales duties in the income year on appeal, thus reducing sales salaries by over \$24,000. By inaugurating the use of its own printing facilities in that year, appellant also decreased its printing expenses by \$53,000,

Respondent has allowed the deduction of the full amount of salary (\$30,000) paid to Zappas but has disallowed, as a deduction, \$6,600 of the \$9,500 bonus as in excess of a reasonable allowance for compensation, regarding it as a distribution of earnings to the sole stockholder.

What is reasonable compensation is dependent upon the facts and circumstances of each particular case. (Mayson Mfg. Co. v. Commissioner, 178 F. 2d 115.) It is well settled that the amount of reasonable compensation determined by the taxing agency carries a clear presumption of correctness and that the burden is upon the taxpayer to prove it is entitled to the compensation deduction, (Botany Worsted Mills v. United States, 278 U.S. 282 (73 L. Ed. 379); Miller Mfg. Co. v. Commissioner, 149 F. 2d 421; National Weeklies, v. Commissioner, 137 F. 2d 39; Crescent Bed Co. v. Commissioner, 133 F. 2d 424; Summitville Face Brick Co., T. C. Memo., Dkt. No. 3032, Aug. 5, 1944.) The burden is imposed upon the taxpayer to remove any stockholder sinecural tinge. (Heil Beauty Supplies, Inc. v. Commissioner, 199 F. 2d 193.)

An important factor in determining the reasonableness of a salary is the prevailing rate of compensation paid by like concerns for similar services, (Gus Blass Co., 9 T.C. 15, appeal dismissed, 168 F. 2d 833.) Appellant relies upon a letter from a company engaged in selling newspaper business, and other businesses, in which the opinion is expressed that a salary of \$39,000 would be reasonable, without detailing specific facts upon which the opinion is based. Appellant also argues that a normal sales commission is 15 percent; that for sales of \$329,662, a reasonable salary would, therefore, be \$49,449; that since sales salaries of other employees were \$24,239, Zappas' commissions could conceivably be the difference, namely, \$25,210, and the balance of the \$39,500 would be reasonable compensation for the performance of

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executive duties. However, the amount of advertising sold by these other salesmen was not stated, nor was the actual rate of their commissions shown.

Respondent states it has examined compensation paid by other newspapers in the Los Angeles area and that in only one case did the compensation of all of the officers together exceed Zappas' compensation, and that was only by about \$500. In that instance, according to respondent, the sales were several times those of appellant. Respondent states that the total officers' compensation of only one additional newspaper exceeded \$32,900, the amount allowed by respondent as a deduction herein,

In view of the vague nature of appellant's opinion evidence, and the absence of sufficient information concerning the basis thereof, appellant has clearly not met the burden of establishing that Zappas received only the prevailing rate of compensation paid by like concerns for similar services.

(Am-Plus Storage Battery Co. v. Commissioner, 35 F. 2d 167; Glenshaw Glass Co., T. C. Memo., Dkt. No. 6994, Oct. 15, 1946, aff'd, 175 F. 2d 776, cert. denied 333 U. S. 842 (92 L. Ed. 1126).)

A substantial increase in compensation without a corresponding increase in duties, moreover, is strong evidence that the increased compensation is in excess of reasonable compensation. (Gus Blass Co., 9 T.C. 15, supra; William P. Neil Co., T.C. Memo., Dkt. No. 3953, April 29, 1946; Summitville Face Brick Co., T.C. Memo., Dkt. No. 3032, Aug. 5, 1944, supra; Glenshaw Glass Co., supra,) Zappas' compensation virtually doubled in 1959 over 1958 notwithstanding he was also performing Mrs. Owens' duties the preceding year. It could be argued that the value of Zappas' services increased in 1959 over the preceding year as demonstrated by the net income increase, in excess of \$4,300, and because of the assumption of additional selling duties. However, double compensation was not warranted. For example, a fifteen percent increase in net profits in the Glass Blass Co. case, supra, was held not to justify even a fifty percent compensation increase. Furthermore, while sales costs went down, there was a sharp decline in gross sales. The increased net income was due primarily to a reduction in printing costs, not to Zappas' selling efforts. It should be noted that respondent has allowed a 48 percent increase in total officers' salaries over 1958, \$44,500 as compared to \$29,970,

In the case of a closely held corporation there is a strong temptation to the stockholding officers to draw off the profits in the form of deductible salaries rather than as nondeductible dividends. Factors indicating that the payments here were based more upon the amount of available profits than upon the value of the services are that the compensation was determined when the profits were known, varying from year to year (Hatfield Packing Co., T.C. Memo., Dkt. Nos. 46734, 49340, Sept. 28, 1955, Republic Publishing Co., T.C. Memo., Dkt. No. 3733, Jan. 25, 1945), and that no dividends were ever paid, (Long Island Drug Co., 35 B.T.A. 328, aff'd, 111 F.2d 593.) The discrepancy between the allocation of salaries on appellant's return and on its records also strongly suggests a dominant motive to obtain a deduction by making the salaries appear reasonable rather than to fairly compensate for services rendered.

A sole stockholder may pay himself whatever salary he wishes, but in order to deduct the entire amount from his corporation's income for tax purposes, he must be prepared to demonstrate that it is reasonable and in line

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with compensation for similar services rendered in similar businesses in which the restraining influence of other owners assures that the salary is not excessive. Where a corporation is closely held, the taxing authorities are the only restraining influence protecting the revenues, While they should not be unduly strict, to be unduly generous not only breaches their obligation to the state but permits an unwarranted tax advantage over competing corporations which are not closely held and whose stockholders draw their profits as normal, nondeductible dividends,

We do not question the ability or industry of appellant's president. Appellant, however, has not established its right to a deduction for his salary in excess of the amount of \$32,900, which has been allowed by respondent.

O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to Section 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Southland Publishing Co., Inc., against a proposed assessment of additional franchise tax in the amount of \$385.12 for the income year ended March 31, 1959, be and the same is hereby sustained,

Done at Sacramento, California, this 7th day of January, 1964,
by the State Board of Equalization,

_____, Paul R. Leake, Chairman

_____, Geo. R. Reilly, Member

_____, John W. Lynch, Member

_____, Member

_____, Member

ATTEST: _____, H. F. Freeman, Secretary